Focus notes: **Turkey**

## Turkey's Central Bank keeps its key policy rate stable, cuts its overnight borrowing rate by 400bps

Turkey's Central Bank kept its key policy rate, the 1-week repo rate, stable at 7.00% at its MPC meeting on November 11, in line with market expectations. The committee also left the overnight lending rate unchanged at 8.75%. However, in a rather unexpected move, the Bank cut the overnight borrowing rate by a much larger that expected 400bps to 1.75%. The latter is considered to be part of CBRT's exit strategy measures and effectively increases further the spread between the overnight borrowing rate and the 1-week repo rate. In a similar move, the Bank also cut the Late Liquidity Window Borrowing Rate to zero from 1.75% previously.

CBRT's latest policy moves aim to support liquidity conditions in the interbank market, since domestic commercial banks will now be discouraged from lending their excess liquidity to the CBRT and, in turn, be encouraged to trade with each other. This is effectively expected to compress further short-term interbank rates and deter "hot money'' portfolio inflows. The latter appear to have exacerbated the lira's recent uptrend, which along with buoyant domestic credit expansion is aggravating the external imbalance and contributing to a widening of the current account deficit.

In the policy statement accompanying the November MPC meeting, the CBRT explicitly noted such concerns. The rest of the statement was broadly similar to that issued at the October policy meting. The MPC repeated that "economic activity continues to recover" and that it will take a long time before industrial capacity utilization returns to pre-crisis levels. Furthermore, although employment conditions continue to improve, the rate of unemployment remains at elevated levels. The Committee reaffirmed its earlier view that inflation will remain on a downtrend in the period ahead and that core inflation is expected to remain consistent with the medium-term targets. The statement also repeated that "it would be necessary to maintain policy rates at current levels for some time, and to keep them at low levels for a long period". The MPC signaled anew that it plans to continue gradually implementing the remaining measures as envisaged in its exit strategy programme.

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The Central Bank has taken a number of steps in recent months as part of its exit strategy measures, aimed at reversing accommodative policies employed during the global financial crisis. Besides the measures decided at the November policy meeting, the Bank has a) changed in May its key policy rate from the overnight borrowing rate to the 1-week repo rate, b) cut its overnight borrowing rate by a cumulative 75bps in September-October, c) canceled its 3-month repo auctions last month and recently tightened reserve requirements. In fact, a day after the November 11 MPC, the Bank announced an increase in reserve requirements on TRY deposits by 50bps to 6%, which it estimates will dry up some TRY 2.1bn ($1.5bn) from the FX market. The move was the second so far this year, after the CBRT raised as of October 1 its reserve requirement on commercial banks to 11% from 10% for FX and to 5.5% from 5.0% for TRY deposits.

To conclude, CBRT's latest moves suggest that the Bank remains confident on the disinflation process but worries about rapid domestic credit expansion and the recent surge in speculative capital inflows. We expect the Bank to continue unfolding the remaining measures envisaged in its exit strategy programme published in April, with further increases in the reserve requirements ratios likely to be delivered in the following months. The CBRT has already signaled that additional moves are on the cards if credit activity shoots up further.

We maintain our earlier view that the CBRT will stay put on policy rates in the coming months and incept its monetary policy tightening cycle not earlier than in Q4 2011 - as noted in the latest Inflation Report, released in October. A premature rate hike in an environment of still benign underlying price pressures would risk exacerbate the lira's uptrend and attract additional speculative inflows.

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